Quarter Notes

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- *Changes in estate taxes on the legislative horizon*
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Bits and Pieces

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REITs rebound up 13% for the year to date.

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We like to meet our managers face to face. So Carol went to Santa Fe, New Mexico to meet the principals at Thornburg Funds & share their insights.

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Most Major Indices Show Losses Year to Date

Market volatility continued throughout the second quarter. Only small stocks represented by the Russell 2000 index had a positive return of 3% for the year. The Dow stocks are down 9%. Tech stocks suffered a major correction. The NASDAQ, after breaking through the 5,000 barrier in March, plunged 37%, breaking below 3200, before rebounding to close just below 4000; off 2.5% for the year to date.

The Fed has been engaged in an active cycle of raising interest rates to restrain growth; six times in the last twelve months. The Fed fears that sustained run away growth will increase inflation and that tightening credit markets will preempt it. By passing up the opportunity to raise rates again at their June meeting, it appears that the Fed believes its actions have begun to work. Most economists expect another rate increase before year end.

We Don't Pay Our Own Estate Tax

We are all forced to sign yearly checks payable to the U.S. Treasury for income taxes, but none of us is going to sign the check for our own estate taxes. Thinking about our own mortality by having to deal with estate planning and taxes are frequently topics for avoidance behavior. It is easier to bury our heads in the sand and to do nothing.

As planners we are always trying to get clients to review their estate plans on a regular basis. With the Federal budget in surplus for the first time in more than 30 years, eliminating "death taxes" is finally getting more than lip service from politicians. There are currently serious legislative initiatives being proposed by both major party candidates for President. Governor Bush would like to eliminate estate taxes entirely, while Vice-president Gore would seek to broaden and accelerate the exemptions allowed before an estate becomes taxable.

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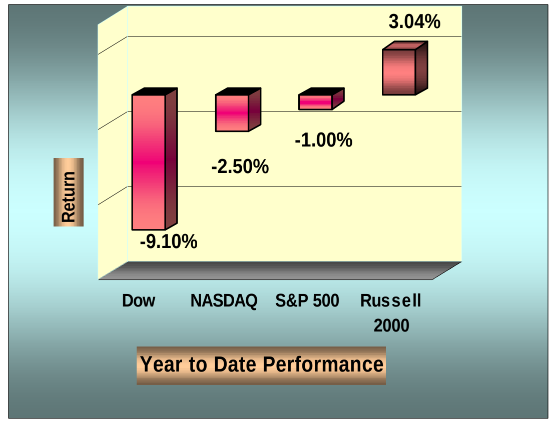

A cautionary note needs to be inserted here. In both proposals the trade off for estate tax relief is likely to be loss of the 'step-up basis ' at death. Under current law, when an individual dies, the cost basis of his assets are "stepped up" to the value as of the date of death. So all capital gains taxes which would have been owed if the assets had been sold before death are now forgiven. Under the new proposals, the owner's original basis would pass to the beneficiary of the asset.

This trade off may make sense. The current marginal estate tax rate is 55% for estates in excess of $3 million. The tax rate for capital gains is currently 20% and taxes are due only on the gains portion, further taxes are not owed until an asset is actually sold by the heirs.

While we're on the subject of estate plans, some clients are under the mistaken belief that if they have a living trust, they have an estate plan. Living trusts are trusts created during the trust maker's lifetime. They are normally revocable or changeable and the maker, called the grantor, is usually the initial trustee. We should add that you should consult an attorney for legal advice specific to your circumstances, but we would like to point out some of the things a living trust can and cannot do as part of an overall estate plan.

Quips for the Quarter

"No investor ever succeeded by buying what was popular when it was popular" *Marty Whitman, Third Avenue Value Fund*

Patience is more important than market timing.

Price is what you pay . . Value is what you get.

Diversification helps protect us from our own dumb mistakes.

Two things can cause a stock to move, the expected and the unexpected.

Estate Planning & Living Trusts

A living trust gives you continuity of management of your financial affairs, by naming a successor trustee of your own choosing in the event that you are disabled mentally or physically either temporarily or permanently. You can be the trustee of your own trust as long as you are able. Upon your death, your trust allows the distribution of property to your heirs more quickly and with potentially fewer estate settlement (probate) costs. Assets held in a trust can pass to your heirs outside of the probate process.

Living trusts do not remove assets from your taxable estate or save you estate taxes. It also will not remove life insurance proceeds from being included in your estate. And most importantly, if you do not retitle your assets and place them in your trust, a trust does you no good at all. You would be amazed at the number of clients who have paid and executed living trusts, but have never retitled their assets to move them into the trust.

In sum a living trust may be a useful tool, but it is only one of many which can be used in a comprehensive estate plan.

Portfolio Manager Visit: Thornburg Funds

We frequently meet with portfolio managers at national conferences or privately at their offices or ours. We enjoy meeting them and hearing about their investment process.

Recently, we went to an educational seminar in Santa Fe, New Mexico and had the opportunity to meet with the portfolio managers at Thornburg Funds. We have used Thornburg as one of our favorite choices, along with Vanguard, for municipal bond fund positions. In addition, some of our clients hold Thornburg Value, a focused, mid to large cap equity fund with a growth-at-a-reasonable-price strategy.

Brian McMahon and Steven Bohlin are Thornburg's top bond managers. They structure laddered portfolios, which means that a certain percentage of the bonds mature every year. This leads to less interest rate risk because, if interest rates rise, the portion maturing can be reinvested at the higher rates.

William Fries, CFA, the lead manager of the Thornburg Value Fund, took us through the process by which they evaluated one stock they currently have in the portfolio,

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Investment Outlook: What lies be ahead?

William E. Dodge, of Delaware Advisors, feels a fair P/E ratio for stocks with average dividends and earnings growing at 6-8% is 16-18 times earnings. The median P/E of the S&P 500 Index and the NYSE Composite are both below this level. However, the shakeout occurring in the "new economy" stocks may continue for some time, but companies with truly compelling future profits will be rewarded.

How does all this effect the bond markets? Since we believe that the Fed is much closer to the end of the tightening cycle than to the beginning, bonds, especially high quality intermediate bonds, are looking very attractive. Lower quality bonds might pose credit risk concerns if the Fed's tightening over-shoots the mark and severely restricts profit growth.

Fed watchers will be looking critically at the Consumer Price Index which will be published on July 18th. The CPI could be up substantially due to the recent rise in energy costs. However, if the core CPI, excluding food and energy, is still growing, the Fed is likely to raise interest rates again in August.

What does all this mean to you? We cannot predict interest rates, nor the markets short term reaction to them. Tactically, now is a good time to fully allocate our bond positions with high quality intermediate term bonds and bond funds. Make sure our equity allocations have not strayed too far away from our targets, especially our allocation to value based strategies, and allow our international positions to provide the diversifying effect which we expect from them.

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a grocery and drug store retail chain. The thing that struck us most as we listened to their analysis was how deeply they delve into the company, its financial data, its stock movement, its growth potential, and its relative and absolute value.

Even after all this analysis, they may decide that there is not enough cushion at its current stock price to buy it for their portfolio. We contrast that with a client calling us up and saying, "XYZ.com's stock is off 20% from its high, I want to buy 1000 shares." If we are truly investors and not merely speculators, the analysis is crucial. It is really impressive when you see it done properly.